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Perspectives on Tax Policy in Small and Open Economies

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The ongoing internationalization of many European and non-European economies has important implications for policies related to public finance. Economies relatively open to trade in financial assets, goods, services and factors of production are likely to respond to tax policy differently than relatively closed economies. The divergent impacts are related to both distributional aspects and allocative efficiency. This volume takes stock of some new insights from research on public finance in open economies. The focus is twofold.

On the one hand, the degree of economic openness establishes further constraints on optimal tax policy. New sources of tax-induced inefficiency may be created by internationalization, and the costs of maintaining old policies may increase. This perspective is further discussed in the contribution by *Christiansen, Hagen* and *Sandmo.* On the other hand, institutional features typical of the open economies in Europe need to be better incorporated into the standard theory of public finance. Examples are labor unions, housing investment, cross-border shopping, monopolies, and pension saving. These extensions often involve market imperfections, which raise second- and third-best issues. Examples of market failures examined in this special issue are environmental externalities, knowledge spillovers, imperfect competition in commodity markets, and labor-market imperfections giving rise to involuntary unemployment.

Higher mobility of financial capital, induced by lower transaction costs and deregulation of capital markets, has attracted considerable attention to the taxation of capital income. The standard normative model assumes perfect mobility of physical capital, while labor and residents are completely immobile. If a government can freely tax labor and country-specific rents, it should not adopt any source-based taxes on capital income. Intuitively, with perfect capital mobility, a source-based tax on capital is shifted to the immobile factor labor. It is better to tax labor directly rather than indirectly through a source-based tax on capital, since the explicit labor tax does not distort production.

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Whereas standard optimal tax theory indicates that a small open economy should not tax investment through source-based taxes on capital income, it suggests that taxes on saving in the form of residence-based capital-income taxes may be part of an optimal tax system. However, capital income taxes are particularly difficult to enforce in small open economies, as residence-based taxes on foreign-source capital income are easily evaded. The main reason is that monitoring of foreign-source income requires cooperation from the countries where the income originates. From the point of view of these countries, however, monitoring amounts to a source-based tax. Since the optimal source-based tax in a small open economy is zero, the source country typically has no incentive to cooperative with the residence country in monitoring income. Indeed, tax havens generally have bank secrecy laws, which prevent financial institutions from transmitting information to tax authorities in other countries.

Whereas small and open economies should not tax highly mobile factors on a source basis, they can in principle tax country-specific rents on real investments. In practice, however, little revenue may be collected, as multinational corporations employ transfer prices and financial devices to shift their taxable incomes across jurisdictions.

The monitoring problems associated with foreign-source financial income and country-specific rents create all kinds of tax arbitrage possibilities. As a result, revenues from capital taxation decline, thereby limiting the scope for redistributing income away from capital to labor income. Moreover, other distortionary taxes have to be raised to make up the loss in revenue, thereby causing additional efficiency losses. If residence-based taxes cannot be enforced, the optimal tax literature suggests that capital income taxes should vanish altogether. In practice, however, a large gap between the tax rates on labor and capital income encourages agents to classify labor income as capital income, since the government cannot monitor the distinction between these income categories very well. In the face of these enforcement problems, governments cannot freely tax labor income and hence may want to tax capital income.

Two other features of open economies are of importance, namely migration and cross-border shopping. The decision to migrate is influenced not only by taxes, but also by public spending. Governments may therefore be able to maintain high levels of taxation as long as the revenues are used to finance public spending which benefits mobile factors (*Christiansen, Hagen* and *Sandmo*). Governments thus have to rely more on the benefit principle in their public spending, which involves two major difficulties. First, countries cannot use the tax and expenditure system to redistribute income away from mobile to immobile factors. Indeed, international integration endangers redistribution and insurance provided by the welfare state. Free labor mobility, for example, aggravates problems of adverse selection associated with social insurance. Second, the benefit principle is difficult to implement, as agents often find ways of escaping taxes while continuing to benefit from public spending. For example, linking taxes to benefits may not be possible if agents can migrate in and out over their life cycle.

Cross-border shopping is another reason why arbitrage across borders can break the link between benefits from public spending and taxes paid. Consumers may enjoy public goods in their residence country, and cross the border to make purchases (which include indirect taxes to foreign governments). In the case of gasoline taxes, for example, cross-border shopping makes it difficult to finance spending on roads through taxes on gasoline. (*Christiansen, Hagen* and *Sandmo* provide more examples.)

The removal of border controls within the EU changes the way intra-EU trade flows are taxed under the value-added tax (VAT) (*Lockwood, de Meza* and *Myles*). The removal of border controls turns the destination regime, under which goods are taxed in the importing country, into a mixed regime where consumer imports are taxed in the country of origin, while imports through firms continue to carry the tax of the country of destination. Within this mixed regime, countries face incentives to pursue beggar-thy-neighbor (tax-cutting) policies in order to exploit cross-border shopping by consumers, and tax-motivated trade by consumers distorts resource allocation.

In order to prevent these harmful effects, *Lockwood, de Meza* and *Myles* propose that custom unions apply the origin principle not only to consumer trade within the union but also to all other trade flows, including those between the union and the rest of the world. One major restrictive condition for this proposal to work properly is that tax rates within countries should be uniform. However, individual countries may well find it optimal to tax commodities at nonuniform rates for various reasons, including terms-of-trade effects, externalities, merit-good arguments, administrative difficulties in taxing particular goods, and Ramsey considerations (*Christiansen, Hagen* and *Sandmo*).

The Ramsey formula for optimal taxes is the same in an open economy subject to cross-border shopping and a closed economy (*Christiansen*). The relevant elasticities may differ, however. In particular, domestic demand may be more sensitive if cross-border shopping is possible, thereby reducing the optimal tax. As a direct implication, the domestic tax rate rises with the foreign price level if higher foreign prices make domestic demand less elastic.

The externalities among countries created by taxation provide an argument for tax coordination among welfare-maximizing governments.

On the other hand, the public sectors may to some extent be populated by politicians and bureaucrats who pursue their own interests rather than those of the electorate. When that is the case, economic integration (without tax coordination) may enhance welfare by restraining the monopoly power of self-interested governments. Tax coordination may then be compared to the formation of a cartel, whereby governments protect a wasteful public sector.

Environmental problems raise new questions in public finance. In what way do green preferences shift the level of public spending (*Bovenberg* and *van der Ploeg*)? Would a small open economy ever want to introduce a carbon tax unilaterally, even though the contribution of such a tax to reducing global emissions of carbon is negligible (*Lund*)? There is also an interesting interaction between environmental taxes and other distortionary taxes or subsidies. Subsidies to stimulate research and development, for instance, may very well lead to more carbon emissions if the use of carbon-intensive inputs is not simultaneously taxed (*Lund*). Similarly, optimal environmental taxes may end up letting immobile labor bear the entire burden of pollution taxes. The result may be reduced employment, even though production becomes more labor-intensive (*Bovenberg* and *van der Ploeg*).

Faced with massive unemployment, however, the most needed tax reforms are perhaps those designed to improve the working of the labor market. One alternative is to implement a tax reform aimed at cutting marginal tax rates and broadening the tax base. Such a policy of tax-cut-cum-base-broadening has been pursued in recent years by several OECD countries, including the Scandinavian countries. Despite the belief of many governments that these reforms should boost employment, this may not always be the case. A lower marginal tax rate (for any given average tax rate on wage income) may tempt unions to increase wages. If unions account for the disutility of work (or alternatively, for utility from leisure in unemployment), a cut in marginal tax rates should stimulate employment and economic activity. If the income when unemployed consists in part of untaxed imputed income from leisure, the cut in marginal tax rates benefits mainly those who are working. Hence, being employed becomes more attractive as compared to being unemployed, so that unions are encouraged to boost employment by moderating wages (*Jensen, Nielsen, Pedersen* and *Sørensen*).

Tax reforms aimed at improving the operation of pension systems have also been much debated in a number of European countries. Occupational pension schemes may raise pension premiums on the income of the young in order to maintain the value of pension benefits paid out to older generations. Yet, moving away from pay-as-you-go pensions to collectively funded systems may benefit all generations. The reason is that the funded plan may improve labor-market incentives by linking retirement benefits to hours worked (*Broer, Westerout* and *Bovenberg*).

This volume concludes with empirical analyses of the role of taxation for savings and investments. Compared to the rest of the OECD, Nordic countries featured low household saving ratios until quite recently. Moreover, Nordic saving ratios declined more markedly during the 1980s than did the corresponding ratios in other OECD countries. What is the impact of the tax system in this connection? *Koskela* and *Virén* find that, in addition to low unemployment rates and demographic variables, high income tax rates have contributed significantly to the relatively poor saving performance of Nordic households. High income taxes or high social security spending (or both) have widened the gap between the level of household saving in the Nordic countries and that found in the rest of the OECD. In the Nordic countries, liberal rules for the tax deductibility of nominal interest expenses have been combined with tax-favored treatment of particular types of saving. Facing these tax rules in combination with relatively high inflation rates, households could borrow at low after-tax real rates and use the funds to finance investments in housing and other forms of wealth subject to low effective tax rates. The liberalization of financial markets in the 1980s allowed households to take more advantage of these tax arbitrage possibilities. Indeed, the rapid rise in housing prices in the 1980s coincided with the liberalization of financial markets.

Marginal effective source-based tax rates on corporate investment have been quite low in the Nordic countries (*Dufwenberg, Koskenkylä* and *Södersten*). During most of the last 25 years, Finland and Sweden exhibited effective rates close to zero, while Denmark and Norway featured relatively small but strictly positive effective rates. In several years, the tax wedges were actually negative in Finland and Sweden. Thus, the positive effects of tax concessions on investment incentives offset the adverse incentive effects of the corporate tax. The corporate tax reforms recently implemented by Finland, Norway and Sweden may have raised the effective tax rates on investment by reducing both tax allowances and statutory corporate rates.